

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:OHI:CIN:TL-N-6391-99  
JEKagy

date:

to: Chief, Examination Division, Ohio District  
Attn: David Orlowski (E:EB6:1636)

from: Assistant District Counsel, Ohio District, Cincinnati

subject: [REDACTED]

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This memorandum responds to your October 9, 1999 inquiry regarding the taxpayer referenced above. In particular, this memorandum addresses your inquiry concerning (1) the proper method of allocating settlement payments between compensatory damages, punitive damages and interest and (2) the information reporting requirements of the taxpayer for payments made to settle various [REDACTED] products liability lawsuits filed against it.

ISSUES:

1. Whether payments made by the taxpayer in satisfaction of multiple [REDACTED] causes of action may be allocated between compensatory damages, punitive damages and interest in accordance with some generally accepted methodology.
2. Whether the taxpayer was required to file information returns relating to the payments made in settlement of various [REDACTED] products liability lawsuits filed against it.

CONCLUSIONS:

1. Payments made by the taxpayer in satisfaction of multiple [REDACTED] causes of action must be allocated between compensatory damages, punitive damages and interest based upon the specific facts and circumstances of each cause of action settled, rather than upon some generally accepted methodology.
2. Informational returns relating to the payments in settlement of various [REDACTED] products liability lawsuits are required to be filed only if, as a matter of fact, the payor is reasonably expected to know the proper allocation of the payments between compensatory damages, punitive damages and interest for each individual recipient.

FACTS:

The taxpayer, together with other former manufacturers, distributors, installers, suppliers and miners of [REDACTED] and [REDACTED] goods, were the defendants to multiple individual and class action personal liability lawsuits. Generally the suits alleged personal injuries stemming from the [REDACTED] of [REDACTED] by the defendant's products. Many of the suits sought punitive as well as compensatory damages.

During the [REDACTED] through [REDACTED] tax years at issue, the taxpayer made payments in the amounts of \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED] respectively, in settlement of certain of the claims against it. As a matter of perspective, by the end of [REDACTED], the taxpayer had settled approximately [REDACTED] claims against it but still was subject to approximately [REDACTED] additional [REDACTED] claims.

Raised by the agents are questions involving (1) the proper allocation of the payments, relative to each payee, between compensatory damages, punitive damages, and interest and (2)

whether the taxpayer (the payor) was required to file information returns regarding the taxable portion of the payments to each of the individual recipients.

ANALYSIS:

Issue 1.

Although accessions to wealth are generally included in gross income under section 61, section 104(a) excludes from gross income the amounts received as damages "on account of personal injuries". In O'Gilvie v. United States, 519 U.S. 79 (1996) the Supreme Court concluded that punitive damages received in a tort suit for personal injuries were not received on account of personal injuries within the meaning of section 104(a) and were not, therefore, excluded from gross income.

The first issue considers the need to distinguish between amounts paid as compensatory damages and those paid as interest and punitive damages. Numerous cases have considered the allocations necessary between different types of damages. See, e.g., Robinson v. Commissioner, 102 T.C. 116, 125 (1994), aff'd in part and rev'd in part, 70 F.3d 34 (1995), cert. denied, 519 U.S. 824 (1996); Horton v. Commissioner, 100 T.C. 93 (1993), aff'd, 33 F.3d 625 (6th Cir. 1994). The common thread connecting the many cases attempting to characterize the payments received by an injured claimant is to ascertain "in lieu of what were damages awarded" or paid. See Bent v. Commissioner, 87 T.C. 236, 244 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987). The Courts have long held that in making that determination, they look to all the facts and circumstances involved to ascertain the true substance and nature of the claim that was settled. See, e.g., Stocks v. Commissioner, 98 T.C. 1, 11 (1992).

One touchstone used by the Courts is the relevant documents used by the parties. See Church v. Commissioner, 80 T.C. 1104 (1988). To the extent the taxpayer's claims were settled pursuant to express language set forth in a written document, the Courts will consider the allocations set forth in those writings. However, to be respected, the allocations set forth in the document must have been negotiated at arm's length between adverse parties. See Threlkeld v. Commissioner, 87 T.C. 1294, 1306-1307 (1986), aff'd, 848 F.2d 81 (6th Cir. 1988). To the extent an allocation in a settlement document was drafted without the participation or approval of an adversarial party, the allocation will generally be ignored. See Mitchell v. Commissioner, T.C. Memo. 1990-617, aff'd, 992 F.2d 1219 (9<sup>th</sup> Cir. 1993).

Important in determining the validity of a document is the "intent of the payor" in making the payment. See Agar v. Commissioner, 290 F.2d 283, 284 (2d Cir. 1961). Other items examined to reach the proper characterization of the payments are factors like the details surrounding the litigation underlying the proceeding, the allegations contained in the complaint and any amendments thereto, and the arguments made by the parties prior to settlement. See Threlkeld, 87 T.C. at 1306.

From the foregoing, it is clear that the Courts do not condone a general generic methodology for allocating a lump sum settlement into its various parts, but require the examination of the individual facts and circumstances of each settled claim. In your instance, each claim settled will need to be examined separately to determine the proper methodology to be applied to the settlement proceeds. Should you desire our assistance in developing document requests to address this issue, we stand ready to assist you.

#### Issue 2.

In general, section 6041(a) provides that all persons engaged in a trade or business and making payment in the course of such trade or business to another person of, among other things, compensation of \$600 or more in any taxable year must file a return prescribed by the Commissioner setting forth the amount of the compensation and the name and address of the recipient.<sup>1</sup> Treas. Reg. § 1.6041-1(a)(2) provides that the return normally necessary is a Form 1096 or 1099.

The requirement to file a Form 1099, however, is not absolute. For instance, in Rev. Rul. 80-22, 1980-1 C.B. 286, the Service addressed a situation where a mutual insurance company made payments of crop insurance to farmers to compensate them for crops damaged by hail. Each recipient farmer was required to capitalize a portion of the payments under either section 278 or 447. The ruling concluded that where the payor is unable to determine either what portion of the payments represent income or what portion amounts to recovery of capital to the payee, and cannot compel the recipient to disclose the information necessary to make the calculation, the payor is not required to file Forms 1099 because the payments are not "fixed and determinable" for purposes of section 6041.

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<sup>1</sup> Various other Code sections impose similar requirements regarding, inter alia, the payment of dividends (§ 6042(a)), patronage dividends by cooperatives (§ 6044(a)(1)), designated employee plan distributions (§ 6047(d)), interest (§ 6049(a)) and royalties (§ 6050N(a)).

A similar conclusion was reached by the Service in LTR 9322026 (March 9, 1993) where the question involved a company's obligation to file information returns relating to settlement payments from an unlawful sales practice suit. The Service ruled that the payor corporation was not required to file information returns under section 6041 because the payor could not have known what portion of each individual payment amounted to taxable income to the payee recipient. Similarly, in LTR 199945023 (August 12, 1999), the Service addressed a situation involving qualified settlement funds (QSFs) under section 468, arising from the settlement of liabilities alleged in an action for tort, breach of contract, or violation of federal or state law. The Service ruled that since the fund did not know the recipient's adjusted basis in the partnership stock at issue in the suit, it could not reasonably determine what part of each payment constituted gain, profit or income to the recipient. As a result, the payments were ruled not to be fixed or determinable and not subject to the reporting requirements of section 6041.

Whether your taxpayer was required to file the information returns pursuant to section 6041 or should be excused pursuant to authority of Rev. Rul. 80-22 is, at least initially, a matter of fact under the authority of the District Director. Considering that each payment must be individually scrutinized to determine the proper allocation of the payment between compensatory damages, punitive damages and interest, it would be somewhat unrealistic to believe the payor should have known what portion of each payment amounted to taxable income to each payee. Nevertheless, we leave it to your discretion, based upon the facts you determine, whether to pursue the section 6041 information return issue.

We hope the foregoing fully addresses the questions raised in your October 9, 1999 inquiry regarding the allocation and reporting issues, but if additional questions arise, please contact the undersigned at 513-684-3211.

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By:

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